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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Price Cap Performance Review	)	CC Docket No. 94-1
for Local Exchange Carriers	)	

COMMENTS OF SPRINT CORPORATION

Respectfully submitted,

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December 18, 1995

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SUMMARY

Sprint agrees with the Commission's tentative conclusion that annual price cap adjustments should be made using a LEC industry-specific, TFP-based adjustment, and agrees with the three essential characteristics the Commission intends to use in developing the long-term price cap adjustment formula: (1) the X-Factor should be economically meaningful; (2) it should ensure that ongoing LEC productivity gains are passed on to customers; and (3) its calculation should be reasonably simple and based on accessible verifiable data.

Because Sprint has found it impossible to reconcile the results reached by using the Christensen TFP approach with LEC industry financial performance, it urges the Commission to pursue a direct approach (LEC input inflation minus LEC TFP) in making price cap adjustments in the long-term LEC price cap plan. Sprint believes a direct approach is more consistent with the Commission's essential characteristics and appropriately provides for the kind of LEC input price differential the Commission seeks. Sprint supports the use of a multiple X-Factor option, with varying sharing requirements and strongly urges the retention of a voluntary no-sharing option. Sprint believes that a separate Common Line adjustment formula should be maintained, but urges that the Commission revise the formula to operate on a per-line basis. Sprint offers a specific per-line methodology. Finally, Sprint argues that the current exogenous cost recovery rules not be revised.

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COMMENTS OF SPRINT CORPORATION

Sprint Corporation ("Sprint"), on behalf of the United and Central Telephone Companies (the "Sprint LECs") and Sprint Communications Company, L.P., hereby respectfully submits its comments in response to the Fourth Further Notice of Proposed Rulemaking ("X-Factor NPRM") released September 27, 1995 (FCC 95-406).[1]

I. INTRODUCTION

In this proceeding, the Commission seeks to implement its tentative decisions from the First Report and Order[2] and requests comment on a number of issues regarding the long-term LEC Price Cap Plan. Specifically, the Commission requests comment on the calculation of the productivity adjustment -- the X-Factor -- and whether the X-Factor should be reviewed and modified periodically

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1. Additionally, Sprint provides its Comments on Issues 19 and 20 from the Second Further Notice of Proposed Rulemaking (FCC 95-393, "LEC Pricing Flexibility NPRM") as requested by the Commission in its Order on Motion for Extension of Time, CC Docket 94-1 released November 13, 1995 (DA 95-2340).

2. Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, First Report and Order, released April 7, 1995 (FCC 95-132).

or set on a permanent basis; on the number of X-Factors to be included in the LEC price cap plan; and the sharing requirements, if any, to be associated with each X-Factor. For purposes of the long-term LEC price cap plan, the Commission also seeks comment on possible changes to the common line formula and on the exogenous cost rules.

The X-Factor was developed to compensate for the fact that LEC productivity has outpaced productivity in the economy as a whole.[3] In the LEC Price Cap Order, the initial X-Factor was established using the average of two Commission studies of carriers' historical unit cost changes.[4] Thereafter, in the First Report and Order, the Commission adopted several revisions to the LEC price cap plan that are to be effective pending adoption of long-term revisions.[5] The interim plan includes two different X-Factors with varying sharing requirements and a third, higher X-Factor that has no sharing obligation. The choice of which X-Factor to use is left to each LEC.

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3. Policies and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Further Notice of Proposed Rulemaking, 3 FCC Rcd 3195 at 3400 and 3405 (1988).

4. Policies and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, Second Report and Order, 5 FCC Rcd 6786 (1990) ("LEC Price Cap Order"). The two studies were the Spavins-Lande Study that examined long-term pricing trends, and the Frentrup-Uretsky Study that focused on revenue and demand trends since 1984.

5. Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, released April 7, 1995 (FCC 95-132) ("First Report and Order").

Additionally, in the First Report and Order the Commission tentatively concluded that the long-term LEC price cap plan should utilize a revised method for calculating the X-Factor.[6] No specifics were adopted; however, the Commission tentatively decided to base this new X-Factor on a total factor productivity ("TFP") method.[7] In this X-Factor NPRM, the Commission now seeks comment on its tentative decision to use the TFP method. As explained more fully below, Sprint agrees with the Commission's tentative conclusion that annual price cap adjustments should be calculated using a LEC industry-specific, TFP-based adjustment, because such factor represents an economically meaningful measure of actual productivity.

Further, the Commission tentatively concluded that the X-Factor should include an adjustment to reflect changes in LECs' input prices.[8] Sprint agrees with the Commission's tentative conclusion because input prices are a key determinant to a LEC's unit cost of output, and thus, such an adjustment is necessary to calculate the annual price cap adjustment. Furthermore, as explained below, Sprint strongly urges the Commission to pursue a direct approach in developing its long-term price cap methodology, rather than using differentials of LEC productivity

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6. First Report and Order at para. 145.

7. X-Factor NPRM at para. 25.

8. X-Factor NPRM at para. 54 and First Report and Order at paras. 160-161.

and input prices relative to the productivity and input prices of the U.S. economy as a whole.

Additionally, in the First Report and Order, the Commission tentatively decided that there should be multiple X-Factors.[9] Sprint agrees that the long-term plan should allow for more than one X-Factor option, because there may be some LECs that are unable to achieve the productivity required by an X-Factor based on industry average productivity. Furthermore, Sprint agrees that one of the options must be a no-sharing option. The Commission took a significant -- and appropriate -- step forward, away from cost of service regulation, when it adopted price caps. The Commission should not step back from either decision by eliminating the no-sharing option.

Sprint also agrees with the Commission's tentative decision to base the X-Factor on an industry-wide measure of performance. This is the best approach to setting the X-Factor because doing so will advance the goal of replicating the incentives created by competition.

Finally, Sprint does not agree that the exogenous cost rules should be revised. There are no changes that are warranted or necessary.

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9. X-Factor NPRM at para. 108 and First Report and Order at para 165.

II. SPRINT SUPPORTS USE OF A TFP METHOD IN CALCULATING LEC PRODUCTIVITY AND ADVOCATES USE OF A DIRECT APPROACH (LEC INPUT INFLATION MINUS LEC TFP) IN THE PRICE CAP FORMULA

In formulating the issues regarding use of a TFP method, the Commission focused its questions on the TFP method proposal contained in the Christensen Study.[10] Additionally, the Commission set forth three essential characteristics that the X-Factor methodology (whether TFP or some other methodology) must satisfy:

> (i) the X-Factor should be economically meaningful, i.e., it should provide a reliable measure of the extent to which changes in LECs' unit costs have been less than the level of inflation;
>
> (ii) the X-Factor should ensure that ongoing gains by the LECs in reducing unit costs are passed through to consumers; and
>
> (iii) calculation of the productivity offset [X-Factor] should be reasonably simple and based on accessible and verifiable data.[11]

As has been the case throughout the LEC price cap performance review proceeding, Sprint has significant practical concerns with the results reached by applying the Christensen approach to the existing price cap formula. However, Sprint agrees with the Commission that these three characteristics are essential to developing the proper annual price cap adjustment. An adjustment

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10. NPRM at para. 22. The Christensen Study was prepared by Christensen, Schoech and Meitzen and was submitted to the Commission by USTA in an ex parte statement filed in this proceeding on January 18, 1995. The Christensen Study measures the TFP of some of the price cap LECs post-divestiture through 1992.

11. X-Factor NPRM at para. 16.

factor that truly incorporates these characteristics should produce a result that balances the needs of the industry, both access suppliers and purchasers, and is administratively simple.

Sprint believes that the determination of an appropriate method for calculating the annual price cap adjustment factor is an important issue not only for the Sprint LECs, significant access suppliers; but also for Sprint Communications L.P., a significant access customer. Throughout this docket Sprint has sought, and will continue to seek, to find a fair middle ground that balances the interests of both price cap LECs and their access customers.

Sprint agrees conceptually with the Commission's tentative conclusion that a TFP approach should be used to compute the annual price cap adjustment. Because TFP studies can be designed to measure LEC productivity growth rates, it is appropriate to include a measure of LEC TFP as a part of the long-term LEC price cap plan. However, solely adopting a TFP differential without other modifications to the existing price cap formula will not truly incorporate the Commission's essential characteristics.

Sprint believes that while the TFP as calculated by the Christensen Study may have theoretical merit,[12] simply plugging these TFP results into the existing formula does not produce a reasonable outcome, or one that is economically meaningful.

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12. Not having thoroughly reviewed the most recent Christensen Study, Sprint cannot comment on either the theoretical or empirical validity of the study. Sprint hopes to be able to do so in its Reply Comments.

Under the initial plan, the base productivity factor was set at 3.3%. Additionally, many LECs, including most of the Sprint LECs, opted for the higher 4.3% productivity offset in order to reduce their sharing obligations. During this period, LEC interstate earnings rose consistently and substantially.[13] Yet, the Christensen Study results imply, and USTA and several price cap LECs argue, that the productivity offset should actually be lower than 3.3%.[14] While rate of return levels should not be the sole focus in price cap regulation, Sprint has found it impossible to reconcile a lower X-Factor in the existing formula with the actual financial performance of the industry.

The variance between Commission-expected and price cap LEC-achieved returns, as well as the more pronounced variance that results from use of a Chritensen-proposed TFP, may result more from the use of GDP-PI in making annual price cap adjustments than from the development of the X-factor. Sprint believes that the GDP-PI is not an accurate surrogate for LEC input price inflation because the components that make up GDP-PI are not reflective of the components of the inputs that make up LECs' input costs. GDP-PI excludes, for example, the

13. The price cap LECs' average earnings, per Form 492s, were 11.67% in 1991, 12.34% in 1992, 12.95% in 1993, and 13.81% in 1994.

14. First Report and Order at footnotes 173-174 and para. 118.

business-to-business transactions that constitute the vast majority of LEC transactions.[15]

While the Christensen Study TFP results may provide a starting point for an estimate of LEC productivity, in order to ensure that on-going gains in LEC unit cost reductions are passed on to consumers, it is necessary, as the Commission recognized, to also acknowledge changes in LEC input prices. The Commission tentatively concluded that an input price differential is a necessary component in the price cap formula. Having so concluded, Sprint believes that the Commission should pursue the direct approach (i.e., LEC input inflation minus LEC TFP) in its long-term price cap plan. Use of the direct approach will obviate the need for GDP-PI, U.S. TFP indices, and U.S. input price indices. In essence, the direct approach reduces a five component formula to a much more straightforward two component formula.[16]

Use of the direct approach is preferable in Sprint's view. A direct approach relies solely on industry-specific information rather than economy-wide data. As noted by the Commission, reliance on economy-wide statistics can introduce a significant lag into the calculation of the X-Factor; for example, there can be a two-year lag in the production of the U.S. TFP statistics by

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15. As much as two-thirds of the economic activity measured in the GDP-PI relates to consumer spending; only one-third of the inputs in GDP-PI are production -- service and manufacturing -- related.

16. The five component formula: GDP-PI - [(TFP_{LEC} - TFP_{US}) - (Input $Inflation_{LEC}$ - Input $Inflation_{US}$)] would be simplified to a two component calculation: (Input $Inflation_{LEC}$ - TFP_{LEC}).

the Bureau of Labor Statistics.[17] Also, use of a differential approach will call into question whether the LEC TFP and LEC input factors can be calculated in a manner consistent with calculation of the respective economy-wide measures.

Sprint has engaged an economic consultant to analyze LEC input inflation. The results are preliminary, but suggest that the difference between GDP-PI and the telecommunications industry input prices from 1984-1993 is significant. Sprint intends to supplement the record as additional analysis becomes available to further substantiate this contention.

III. A VOLUNTARY NO-SHARING OPTION MUST BE PROVIDED

The Commission sought comment on several issues regarding the continued use of sharing as an incentive to LECs to choose the appropriate X-Factor. Specifically, the Commission asked whether multiple X-factor options, with various sharing and no sharing requirements are necessary, and whether mechanisms other than sharing can be developed that will incent LECs to achieve efficiencies and higher levels of productivity.[18] Sprint believes that a no-sharing option must be provided and that it is the only mechanism that will truly incent LECs to achieve higher levels of productivity.

Sprint believes that, ideally, sharing options need not be a part of the long-term LEC price cap plan. The process of sharing

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17. X-Factor NPRM at para. 61.

18. X-Factor NPRM at paras. 114-16.

keeps alive many of the flaws associated with cost of service regulation. Thus, Sprint applauds and strongly supports the Commission's tentative finding that in the long run, sharing should be eliminated.[19] Additionally, Sprint believes that the carrot of a no-sharing option is the only incentive or safeguard that will truly incent LECs to achieve higher levels of productivity. However, Sprint realizes that it is unlikely that all price cap LECs will be able to achieve results that meet or exceed industry average productivity, and thus implementing only a single high, no-sharing option is probably not achievable.

Accordingly, as a baseline standard, the Commission should eliminate sharing requirements for all price cap LECs that elect a productivity offset that incents the LEC to significantly exceed the industry average level of productivity.[20] To the extent that lower X-Factor options are necessary and made available, Sprint believes the sharing requirement is the only safeguard that discourages LECs able to achieve higher levels of productivity from choosing a lower X-Factor.

If the step between the sharing X-Factor(s) and the no-sharing X-Factor, and the sharing ranges for the sharing X-Factor option(s) are properly designed, then sharing will effectively be eliminated. Companies will only choose a sharing option if they believe they are unable to achieve the no-sharing

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19. X-Factor NPRM at para. 114.

20. Sprint believes the Commission's approach in the First Report and Order is an acceptable approach in this regard.

productivity level and expect their earnings to fall below the sharing threshold of the sharing option. Companies will be incented to step up to the no-sharing option X-Factor because of the earnings incentives that such option creates.

Assuming multiple sharing options are a part of the long-term LEC price cap plan, then it is appropriate that LECs have an annual selection to choose a higher X-Factor that provides a lesser or no-sharing obligation. However, once a LEC elects the higher, no-sharing X-Factor, it should be required to stay with that no-sharing option. Year to year selections to lower, sharing X-Factor options would only create incentives for LECs to game the process and should not, therefore, be allowed.

Finally, in the LEC Pricing Flexibility NPRM, the Commission sought comment on whether additional pricing flexibility could provide the incentive for LECs to elect the no-sharing X-Factor and, if mandatory X-Factors are adopted, whether the level of competition faced by a LEC could be the basis for assigning an X-Factor.[21] Sprint believes that both issues must be answered in the negative.

While Sprint believes that the Commission should grant price cap LECs additional pricing flexibility through full implementation of zone density pricing,[22] such additional pricing

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21. LEC Pricing Flexibility NPRM at paras. 160 and 161.

22. See, the December 11, 1995 Comments of Sprint Corp. in response to the LEC Pricing Flexibility NPRM at pages 11-13.

flexibility is not the proper incentive to drive greater levels of productivity and there is nothing on the record in this docket to suggest otherwise.

Furthermore, competition - as suggested by NYNEX or otherwise[23] - is not an appropriate criterion for granting LECs additional productivity factor options, especially on the record before the Commission. There is no record evidence of a direct correlation between competition and productivity and little record of the existence of meaningful competition. Given that competition in the access services market is in its infancy, at best, there is, and can be, no factual evidence to support such a proposition at this time. Finally, as set forth above, the Commission should not prescribe X-Factors for particular carriers.

IV. A PER-LINE COMMON LINE FORMULA SHOULD BE ADOPTED.

The Commission sought comments on whether it should maintain a separate formula for the Common Line basket or whether an X-Factor based on a TFP approach might make a separate common line formula unnecessary.[24] Sprint believes a separate formula must be maintained so long as there is a CCLC.[25] The Commission

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23. LEC Pricing Flexibility NPRM at para. 165.

24. X-Factor NPRM at para. 132.

25. In its December 11, 1995, Comments in the LEC Pricing Flexibility NPRM, Sprint suggested, at pages 7-11, that the CCLC be phased out.

tentatively decided that if a separate common line formula is kept, then the formula should be revised to be a per-line formula instead of the existing "Balanced 50-50."[26] Sprint agrees with this decision.

A per-line formula is appropriate and will ensure that common line revenue growth tracks line growth, consistent with the non-traffic sensitive nature of common line costs. Although it is possible that an X-Factor could capture and incorporate common line minute of use growth on an on-going basis, the effect would be inappropriately spread to all baskets rather than being directly applied to carrier common line charges.

Additionally, Sprint recommends the adoption of following common line per-line capping mechanism. Upon adoption, common line revenue per line should be capped at the base year level. The cap would be adjusted annually for PCI changes. The cap would be multiplied by base period lines each year and EUCL revenue would be subtracted to derive CCL revenue. The CCL revenue would be divided by base year MOU to derive the new CCL per minute charge.[27]

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26. Id.

27. It must be noted that adoption of this per-line formula will require an adjustment in any measure of historical productivity that the Commission uses in establishing the X-Factor so as to avoid a double counting effect. For example, in a TFP measure, the basis for the common line output growth component should be line growth instead of MOU growth. This will ensure that the TFP measure is consistent with the per line approach.

V. THE EXOGENOUS COST RULES SHOULD NOT BE REVISED

In the First Report and Order, the Commission modified the exogenous cost rules to deny exogenous treatment for accounting rule changes that do not affect a carrier's discounted cash flow.[28] The Commission also tentatively concluded that it might be possible to fashion an X-Factor that would recognize most of the costs for which exogenous treatment is granted and thereby obviate the need for exogenous cost treatment except for items that are truly unique for individual LECs. The Commission has sought comment on these tentative conclusions.

Sprint does not believe that an X-Factor can be developed that will capture all of the costs that currently are exogenous, and Sprint, therefore, advocates that the current exogenous cost rules, including the requirement that accounting rule changes are exogenous only if they affect a carrier's discounted cash flow, be left intact. By their very nature, the items that currently receive exogenous treatment are out of the ordinary and beyond the control of the LEC and therefore cannot be anticipated by any X-Factor formula.

The Commission also requested comment on MCI's suggestion that exogenous cost treatment be limited to Commission-ordered changes that result in shifting costs between the interstate and intrastate jurisdictions, or between regulated and non-regulated accounts. Sprint does not agree with MCI's suggestion. Such a limitation is unnecessary and unwarranted, and would thwart the

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28. Paras. 293-296.

purpose of exogenous cost treatment to ensure that the price cap formula does not lead to unreasonably high or unreasonably low rates.

VI. CONCLUSION

Sprint recommends that the TFP method be used to calculate the X-Factor, that the X-Factor include an adjustment to reflect changes in LECs' input prices, and that the X-Factor be based on a LEC industry-wide measure of performance. More fundamentally, Sprint urges the Commission to include a direct approach, i.e., LEC input inflation minus LEC TFP, in the price cap adjustment methodology in its long-term price cap plan. Sprint also supports the eventual elimination of sharing and agrees that at this time there should be multiple X-Factor options provided that one of them is a no-sharing option. Sprint agrees with the Commission that the common line formula should be revised as a per line formula. However, Sprint does not agree that any changes to the exogenous cost rules are necessary.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I, Melinda L. Mills, hereby certify that I have on this ~~26th~~ 11th day of ~~December,~~ January 1995, sent via U.S. First Class Mail, postage prepaid, or Hand Delivery, a copy of the foregoing "Comments of Sprint Corporation" in the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, filed this date with the Acting Secretary, Federal Communications Commission, to the persons on the attached service list.

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